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No. 672

In the Supreme Court of the United States

OCTOBER TERM, 1931

PLANTERS COTTON OIL COMPANY, INC., OF WAXAHACHIE, TEXAS, ET AL., PETITIONERS

v.

GEORGE C. HOPKINS, COLLECTOR OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The opinion of the District Court (R. 24–27) is reported in 47 F. (2d) 659. The opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 32–35) is reported in 53 F. (2d) 825.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered November 20, 1931. (R. 35.) Petition for certiorari was filed February 1, 1932, and was granted March 21, 1932. (R. 36.) Jurisdiction is

conferred upon this Court by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Two affiliated Texas joint-stock associations had a net loss for the taxable year ending in 1924. Three corporations were formed in the following taxable year with which the associations became affiliated. All of the corporations had a net income for that year, but both associations again sustained a loss. The consolidated return for all five companies showed a net income for the year. May the affiliated group deduct the net losses sustained by the associations for the taxable year ending in 1924 in computing the taxable income of the consolidated group for the taxable year ending in 1925?

This question is the same as that presented in *Woolford Realty Co.* v. *Rose, Collector,* No. 582, October Term, 1931, now pending on certiorari.

2. Whether, if the above question is answered favorably to the Collector in the *Woolford case,* the instant case should be distinguished from it and the net losses of the associations for the preceding year be deducted in computing the consolidated net income for the taxable year, because one person owned practically all of the stock of all the companies here involved during the years in question.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations are set forth in the Appendix, *infra,* pages 13–17.

STATEMENT

This suit was brought in the District Court for the Northern District of Texas to recover $8,881.80, paid as income taxes and interest by the Planters Cotton Oil Company (Inc.), Waxahachie, Texas, for the fiscal year ending June 30, 1925. (R. 1, 4, 7.) The parties having waived a trial by jury (R. 8), the court made the following findings of facts (R. 21–23, 9–16):

Petitioners Planters Cotton Oil Company, Waxahachie, Texas, and Planters Cotton Oil Company, Ennis, Texas, were joint-stock associations, H. N. Chapman owning 1,475 of the 1,500 shares of the stock of the former and 2,457 of the 2,500 shares of the latter. (R. 11.) The two associations filed a consolidated return as affiliated corporations for the fiscal year ending June 30, 1924, showing a total net loss of $206,031.03.

On August 18, 1924, two of the other petitioners, Planters Cotton Oil Company, Inc., Waxahachie, and Planters Cotton Oil Company, Inc., Ennis, were incorporated under the laws of Texas, and on September 6, 1924, the remaining petitioner, Farmers Gins, Inc., was also incorporated under the laws of Texas. The two joint-stock associations and the three corporations were affiliated during the fiscal year ending June 30, 1925. (R. 11–12.) H. N. Chapman received 1,940 of the 2,000 shares of the stock of the Planters Cotton Oil Company, Inc., Waxahachie, 2,940 of the 3,000 shares of the

Planters Cotton Oil Company, Inc., Ennis, and 1,204 of the 1,250 shares of Farmers Gins, Inc. This stock was issued in consideration of the transfer to the corporations of certain assets held by the two joint-stock associations. (R. 12.)

On September 17, 1925, the five petitioners filed a consolidated income-tax return for the fiscal year ending June 30, 1925, showing a net income of $69,237. (R. 12–13.) Each of the corporations reported net income for the year, totaling $147,636.25, while the two joint-stock associations each reported a net loss, totaling $78,399.25.

This return did not set forth any claim for deduction of the net loss sustained by the joint-stock associations for the fiscal year ending June 30, 1924. (R. 14.) The Planters Cotton Oil Company, Inc., Waxahachie, paid the total tax computed on the consolidated return, which amounted to $8,654.62, together with $54.80 interest. Later an additional tax of $173.10 was assessed against the affiliated companies and was also paid by Planters Cotton Oil Company, Inc., Waxahachie. (R. 13.)

On September 15, 1927, there was filed an amended consolidated return for the taxable year in question, together with a claim for refund in which it was asserted that a deduction against the total net income of the three corporations should be allowed for the net loss sustained by the two joint-stock associations during the preceding taxable year. (R. 14.) It was agreed that if this net

loss should be allowed, the consolidated group had no taxable net income for the year in question. (R. 14.) The Commissioner of Internal Revenue rejected the claim for refund on March 26, 1928. (R. 15.)

The District Court gave judgment against the petitioner (R. 18–19), and this action was affirmed by the Circuit Court of Appeals (R. 35).

SUMMARY OF ARGUMENT

This case involves substantially the same question as that in *Woolford Realty Co., Inc.*, v. *J. T. Rose, Collector of Internal Revenue,* No. 582, October Term, 1931, now pending on writ of certiorari. Its disposition should be determined entirely by the decision of this Court in the *Woolford case,* and the arguments set forth in the brief for the Collector in that case are equally applicable here. The fact that in this case one person owned substantially all of the stock of the five affiliated companies during the taxable year involved, and also all of the stock of the two associations during the preceding taxable year when they were not affiliated with the three corporations, does not distinguish it from the *Woolford case.* The taxpayers in the instant case are the five companies, and not Chapman, the owner of their stock. To allow the distinction contended for by petitioners would necessitate disregarding corporate entities, contrary to settled law. *National Slag Co.* v. *Commissioner,* 47 F. (2d) 846 (C. C. A. 3d), is contrary

to the decision of the court below in the instant case, and, we believe, incorrect. The decisions of this Court cited by petitioners in support of their contentions do not involve the question of a deduction and are distinguishable.

ARGUMENT

I

This case involves substantially the same question as that presented in *Woolford Realty Co., Inc.*, v. *J. T. Rose, Collector of Internal Revenue,* No. 582, October Term, 1931, now pending on writ of certiorari. Two affiliated joint-stock associations [1] sustained statutory net losses for the taxable year ending in 1924. During the fiscal year ending in 1925 the two associations were affiliated with three other corporations created during that year. The associations again suffered losses for that year, but the corporations all reported net incomes. The consolidated return of all five organizations for that year showed a net income; but if the net losses of the associations for the fiscal year ending in 1924 should be deducted in computing the consolidated net income for the following taxable year, there would be no consolidated net income. Petitioners contend this deduction should be allowed under Section 206 (b) of the Revenue Act of 1926. (*Infra,* p. 14.) For the reasons set forth in the

[1] Joint-stock associations are corporations within the meaning of the Revenue Acts. (Section 2 (a) (2), Revenue Act of 1926, c. 27, 44 Stat. 9.)

brief for the Collector in the *Woolford case* we believe that it should not be allowed and that the decision of the court below was correct. Should this Court decide in favor of the petitioner in the *Woolford case*, it must necessarily give judgment for the petitioners here.

II

We believe that the decision in the *Woolford case*, regardless of which way it is decided, will be determinative of the instant case. The petitioners, however, argue that even if the *Woolford case* is decided against the petitioner there, this case should be decided in their favor. They contend that because one individual owned practically all of the stock of all five companies during the taxable year involved and also of the associations during the preceding taxable year, this fact distinguishes the instant case from the *Woolford case*. As the assets of the corporation came from the associations, it is urged that there was in reality a business unit with one real owner during both of the years in question, and as this owner suffered a net loss in the business unit during one year he should be allowed to deduct the loss from its net income for the following year. If this is not allowed, it is said that the owner will be unjustly deprived of a deduction which he suffered in his business during a preceding year and which is ordinarily allowed under the statute where a single business unit is involved. The court below held that the rule which

it applied in the *Woolford case* was equally applicable here and that ownership of the stock in all of the companies by one individual did not affect the result.

As such a deduction is not provided for in the Revenue Act, for the reasons stated in the respondent's brief in No. 582 it is apparent that the basis of the petitioners' contention is that the corporate entities must be disregarded and the five companies considered simply as a single business personally conducted by Chapman. We believe that a complete answer to petitioners' argument for the disregard of the corporate entities is that Chapman did not choose to operate the business conducted by the five companies individually, nor did he choose to continue the operation of the business wholly by the two joint-stock associations. By creating the three new corporations and transferring to them a portion of the assets of the associations there was effected a change in legal relationships which cannot be ignored by the tax collector. The assets transferred to the corporations were thereafter owned and operated free from the personal liability formerly resting on the stockholders as members of the joint-stock associations. Rev. Civ. Stats., Texas, 1925, Title 105, c. 2, Arts. 6135–6138; *Hollister* v. *McCamey,* 115 Tex. 49; *Manufacturers' E. Co.* v. *Cisco C. & C. Co.,* 118 Tex. 370. The corporations were separate and distinct from the associations. *United States* v. *Phellis,* 257 U. S. 156;

Rockefeller v. *United States,* 257 U. S. 176; *Marr* v. *United States,* 268 U. S. 536. It is, of course, axiomatic that a corporation is an entity separate and distinct from its stockholders. *Eisner* v. *Macomber,* 252 U. S. 189, 213–214; *Peterson* v. *C. R. I. & Pac. Ry.,* 205 U. S. 364. In the absence of fraud or an attempt to evade taxes, the distinction is observed in the application of the revenue laws. *Darby-Lynde Co.* v. *Commissioner,* 51 F. (2d) 32 (C. C. A. 10th), certiorari denied November 2, 1931, 284 U. S. xvii; *McDonald* v. *Commissioner,* 52 F. (2d) 920 (C. C. A. 4th); *Wagner* v. *Lucas,* 38 F. (2d) 391 (App. D. C.).

The language of this Court in *Klein* v. *Board of Supervisors,* 282 U. S. 19, involving the construction of a Kentucky statute taxing corporate shares, is particularly applicable here. It is said (p. 24):

> But it leads nowhere to call a corporation a fiction. If it is a fiction it is a fiction created by law with intent that it should be acted on as if true. The corporation is a person and its ownership is a nonconductor that makes it impossible to attribute an interest in its property to its members. *Donnell* v. *Herring-Hall-Marvin Safe Co.,* 208 U. S. 267, 273.

The five companies, not Chapman, are the taxpayers in the instant case. The statute neither requires nor permits the determination of tax liability by ignoring corporate taxpayers and treat-

ing the problem as if the tax was imposed on their shareholders.

The Board of Tax Appeals has held that where one corporation has acquired all the assets and owned all the stock of another it may not deduct the latter's net loss. *Standard Silica Co.*, 22 B. T. A. 97. The Board has also denied a deduction where the stock of a new company, which had acquired all the assets of a predecessor, was owned by the same individuals in the same proportion as that of the predecessor. *West Point Marion Coal Co.*, 19 B. T. A. 945. In *Athol Mfg. Co.*, 22 B. T. A. 105, a new corporation was formed with the same name as its predecessor, and it took over all the assets and liabilities of the predecessor. An estate owned approximately 94% of the stock of both companies. The Board held that the new corporation could not deduct a net loss sustained by the old. Affirmed as *Athol Mfg. Co.* v. *Commissioner*, 54 F. (2d) 230 (C. C. A. 1st).

The courts have refused to allow one corporation to take the benefit of the deduction of another corporation, or of an individual or vice versa, even where in some cases the stockholders of both have been the same. *Nixon* v. *Lucas*, 42 F. (2d) 833 (C. C. A. 2d); *Burns* v. *Commissioner*, 31 F. (2d) 399 (C. C. A. 5th), certiorari denied, 280 U. S. 564; *Mastin* v. *Commissioner*, 28 F. (2d) 748 (C. C. A. 8th); *Walker* v. *Gulf & I. Ry. Co. of Texas*, 269 Fed. 885 (C. C. A. 5th).

The decision of the Circuit Court of Appeals for the Third Circuit in *National Slag Co.* v. *Commissioner,* 47 F. (2d) 846, is directly contrary to the decision of the court below. We believe that the decision in the *Slag case* is wrong, for the reasons set forth above and for the additional reasons indicated in respondent's brief in the *Woolford case.* A deduction should not be allowed "on principle," as in the *Slag case,* but only if authorized by statute.

Petitioners cite *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330, and *Gulf Oil Corp.* v. *Lewellyn,* 248 U. S. 71, in support of their contentions in this case. We believe that these cases are distinguishable. Neither case involved the question of a statutory grant of a deduction. Each depends upon its peculiar facts presenting a situation which this Court felt would justify the view that a parent company had actual possession and control before March 1, 1913, of amounts sought to be taxed as dividends because of domination of its subsidiary. In both cases one corporation, the taxpayer, owned the stock and exercised control over another corporation. The language of the Court in those cases is to be construed in the light of these facts and it certainly can not be interpreted to mean that the separate corporate entity is to be respected when that will be of advantage to its stockholders but that it must be disregarded when that will operate to the

detriment of the stockholders, as petitioners apparently contend.

CONCLUSION

The decision of the court below was correct and should be affirmed.

Respectfully submitted.

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APRIL, 1932.

APPENDIX

Revenue Act of 1924, c. 234, 43 Stat. 253, 260:

SEC. 206. (a) As used in this section the term "net loss" means the excess of the deductions allowed by section 214 or 234 over the gross income, with the following exceptions and limitations. (U. S. C., Title 26, Sec. 937.)

* * * * *

Revenue Act of 1926, c. 27, 44 Stat. 9, 10, 17, 41, 46:

SEC. 2. (a) When used in this Act—

(1) The term "person" means an individual, a trust or estate, a partnership, or a corporation.

(2) The term "corporation" includes associations, joint-stock companies, and insurance companies.

* * * * *

(9) The term "taxpayer" means any person subject to a tax imposed by this Act. (U. S. C. Sup. V, Title 26, Sec. 1262.)

SEC. 200. When used in this title—

(a) The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under section 212 or 232. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December. The term "taxable year" includes, in the case of a return made for a fractional part of a year under the provisions of this title or under regulations pre-

scribed by the Commissioner with the approval of the Secretary, the period for which such return is made. The first taxable year, to be called the taxable year 1925, shall be the calendar year 1925 or any fiscal year ending during the calendar year 1925. (U. S. C. Sup. V, Title 26, Sec. 931.)

SEC. 206. (b) If, for any taxable year, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount thereof shall be allowed as a deduction in computing the net income of the taxpayer for the succeeding taxable year (hereinafter in this section called "second year"); and if such net loss is in excess of such net income (computed without such deduction), the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year (hereinafter in this section called "third year"); the deduction in all cases to be made under regulations prescribed by the Commissioner with the approval of the Secretary.

* * * * *

(e) If for the taxable year 1923 a taxpayer sustained a net loss within the provisions of the Revenue Act of 1921, or if for the taxable year 1924 a taxpayer sustained a net loss within the provisions of the Revenue Act of 1924, the amount of such net loss shall be allowed as a deduction in computing net income for the two succeeding taxable years to the same extent and in the same manner as a net loss sustained for one taxable year is, under this Act, allowed as a deduction for the two succeeding taxable years.

* * * * *

(g) The benefit of this section shall be allowed to the members of a partnership, to an estate or trust, and to insurance companies subject to the tax imposed by section 243 or 246, under regulations prescribed by the Commissioner with the approval of the Secretary. (U. S. C. Sup. V, Title 26, Sec. 937.)

SEC. 232. In the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by sections 234 and 206, * * *. (U. S. C. Sup. V, Title 26, Sec. 984.)

SEC. 240. (a) Corporations which are affiliated within the meaning of this section may, for any taxable year, make separate returns or, under regulations prescribed by the Commissioner with the approval of the Secretary, make a consolidated return of net income for the purpose of this title, in which case the taxes thereunder shall be computed and determined upon the basis of such return. If return is made on either of such bases, all returns thereafter made shall be upon the same basis unless permission to change the basis is granted by the Commissioner.

(b) In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each. There shall be allowed in computing the income tax only one specific credit computed as pro-

vided in subdivision (b) of section 236. (U. S. C. Sup. V, Title 26, Sec. 993.)

Regulations 69:

ART. 635. *Consolidated net income of affiliated corporations.*—Subject to the provisions covering the determination of taxable net income of separate corporations, and subject further to the elimination of intercompany transactions (whether or not resulting in any profit or loss to the separate corporations), the consolidated taxable net income shall be the combined net income of the several corporations consolidated. Only one specific credit of $2,000, as provided in section 236 (b) and article 591, shall be allowed the consolidated group, and this only in case the net income of the group does not exceed $25,000; but if such net income is more than $25,000, the tax imposed by section 230 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000. In respect of the statement of gross income and deductions and the several schedules required under Form 1120, a corporation filing a consolidated return is required to prepare and file such statements and schedules in columnar form to the end that the details of the items of gross income and deductions for each corporation included in the consolidation may be readily audited.

ART. 1622. *Claim for allowance of net loss.*—A taxpayer sustaining for any taxable year a "net loss" as defined in section 206 (a) and article 1621 may file a claim therefor with his return for the succeeding taxable year (referred to in article 1623 as the "second year"). The claim should contain a concise statement setting forth the amount

of the net loss and all pertinent facts relative thereto, including a schedule showing the computation of the net loss in accordance with section 206 and articles 1621 and 1626. If the evidence furnished satisfies the Commissioner that the taxpayer has sustained a "net loss," the amount of such net loss may be allowed as a deduction in computing the net income of the taxpayer for the succeeding taxable year, and if such net loss is in excess of the net income (computed without such deduction (for that year, the amount of the excess may be carried over and allowed as a deduction in computing the net income for the next succeeding taxable year (referred to in article 1623 as the "third year"). It should be noticed, however, that a "net loss" for a preceding year may not be considered in computing a "net loss" for a succeeding year. (See section 206 (a).)

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